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# THE CRISIS AND THE GLOBAL ECONOMY: A Shifting World Order?

By Razeen Sally

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## EXECUTIVE SUMMARY

THE GLOBAL ECONOMIC crisis has sparked short-term divergence of economic performance between the West and emerging markets, and thereby accelerated the longer-run convergence of the latter on the former. This Shift to the East is also even more evident in international trade and FDI than it is in other channels of globalisation.

But emerging markets' political and economic institutions, and intra-regional divisions, continue to hold back their rise. That means the Shift to the East will not translate into Chinese or other emerging-market leadership for a long time to come – if ever. The USA is still the fulcrum of international relations, and the world is far from being “post-American”. Thus the economic shift to emerging markets, accelerated by the crisis, does not translate into a paradigmatic shift in global political-economic order. But it does insert more multipolarity and uncertainty into that order, and leaves more of a leadership vacuum.

Governments' responses to the biggest deglobalisation since the Depression did not precipitate a descent into 1930s-style protectionism. Domestic crisis interventions – a combination of bank bailouts and expansive macroeconomic policies – took priority. Traditional protectionism hardly increased; borders remained open. But crisis interventions and the return to Big Government leave the West with crippled public finances and more restrictions on competitive markets. Also, they threaten to spill over into creeping protectionism of the subtle, non-tariff, regulatory variety.

The short-term challenge is to arrest the slide to Big Government at home and creeping protectionism abroad. The medium-term challenge is to get back on track with trade and FDI liberalisation combined with domestic structural reforms – substantial unfinished business left before the crisis struck. The BRICS and many other emerging markets still have big pockets of up-front trade and FDI protection. They have even higher domestic (though still trade-related) barriers embedded in services regulation, intellectual property rules, public procurement, customs administration, food-safety and assorted product standards, and competition rules. They do badly on business-climate indicators compiled by the World Bank and other organisations. But “second-generation” reforms to tackle these barriers are much more complex and politically sensitive than the “first-generation” reforms of the Washington Consensus heyday. Compared with border barriers to trade and FDI, domestic regulatory barriers are defended by more powerful, entrenched interest groups, uniting insider elites in government, business and unions, usually with the public sector and the organs of the state at their core.

## 1. INTRODUCTION

WORLD TRADE IS recovering from its steepest fall since the 1930s – part of the biggest “deglobalisation” the world has seen since the Great Depression. The good news is that rampaging 1930s-style protectionism has not returned; indeed new crisis-related protectionism has been remarkably restrained. But protectionism has resurfaced nonetheless, creeping out of the thicket of domestic “crisis interventions” and the seeming return to “big government”. Trade liberalisation had already stalled around the world before the crisis; the latter, predictably, increased all-round defensiveness.

The global economic crisis has also ushered in a dramatically different political and economic context compared with benign pre-crisis conditions. It has narrowed the gap between the West and emerging markets. An anaemic recovery and pervasive gloom cloud the West;

talk of American decline and Eurosclerosis is back in fashion. Roaring growth and sunny optimism brighten emerging-market skies, especially in Asia; China and India shine brightest of all. But skies also shine brightly in parts of Africa and Latin America, notably Brazil. Russia has also rebounded after a searing recession.

My task is to make sense of this post-crisis state of play in international trade, and to take a forward look at emerging markets and global trade policy. In Section 2, I start by describing the political and economic context for international trade up to 2007/8. Section 3 summarises crisis-induced “deglobalisation” and its differential impact on the West and emerging markets. The next section surveys the global economic climate following macro- and micro-economic interventions to combat the crisis, and the seeming return to “big government”. Again, comparisons are made between the West and emerging markets. Section 5 goes on to assess crisis-related protectionism. Section 6 “reviews the troops” – the major players in global trade policy. It starts with the USA and EU, and goes on to cover Japan and major emerging markets (China, India, Brazil, Russia and South Africa). Section 7 covers the WTO and G20, and makes some observations about emerging markets in regional and global economic governance.

## 2. THE GOLDILOCKS GLOBAL ECONOMY BEFORE THE CRISIS

THE PRE-CRISIS GLOBAL economy enjoyed golden conditions. The quarter-century up to the crisis saw the fastest increase in economic growth, globalisation and prosperity in history. International trade increased sevenfold between 1980 and 2008, outpacing the increase in world GDP in the same period; world foreign direct investment (FDI) far outpaced both. The global stock of outward FDI increased from USD 579 billion in 1980 to USD 16206 billion in 2008. The number of transnational companies in 2008 was estimated at 82 000, with 810 000 affiliates representing sales of USD 30 trillion.<sup>1</sup>

The global economy had its “Goldilocks” moment in the half-decade from 2002. Growth, trade and FDI soared to ever-greater heights; financial globalisation soared even higher. Comparative advantage worked in textbook fashion. Labour-abundant Asia rose, powered by the opening and global integration of China and, to a lesser extent, India. China became deeply enmeshed in east-Asian manufacturing supply chains linked to final markets in the West. Resource-abundant Latin America, Africa and the Middle East did well in a China-led commodity supercycle. And the capital- and technology-abundant West also prospered.

Modern globalisation has two engines: technology and policy liberalisation. Technological innovation has slashed the transaction costs of trade by shrinking physical distance; the information-technology (IT) revolution – a combination of the Internet and mobile phones – has obliterated it altogether. Advanced IT has created new global manufacturing supply chains as well as new, highly tradable services sectors.

But technological innovation has not occurred in a vacuum; it has been enabled by internal and external policy liberalisation. *Internal liberalisation* has reduced or eliminated regulations in product, capital and labour markets, thereby liberating the “animal spirits” of competition and entrepreneurship. This was the essence of the Reagan, Thatcher and European Single-Market revolutions in the 1980s and early 1990s. *External liberalisation* has lowered barriers to cross-border trade and investment. Developing countries liberalised massively and integrated into the global economy in the 1980s and ‘90s, with ex-Soviet economies following from the early 1990s. Average tariffs in developing countries fell from about 30 per

cent in 1985 to just above 10 per cent in 2005. There were corresponding reductions in non-tariff trade barriers, FDI restrictions and restrictions on trade in services. The Washington Consensus reigned, reaching its apogee in the late 1990s. According to Jeffrey Sachs and Andrew Warner, around a quarter of the world's population lived in open economies in 1980. By 1993, a majority of humanity lived in (more or less) open economies.<sup>2</sup> Today, adding China and India, that figure is closer to 90 per cent.

Finally, there was a conducive geopolitical environment. America became the sole superpower in the 1990s, replacing Cold War bipolarity. And global economic institutions, especially the IMF, World Bank and WTO, were at the height of their powers.

This was the global economic and geopolitical context for major emerging markets until 2008. The BRICS (Brazil, Russia, India and China) and other large emerging markets (such as Indonesia, Mexico and South Africa) undertook massive external liberalisation in the previous two decades. They became much more globalised, with increasing trade volumes, trade-to-GDP ratios, growing shares of world trade and exported value-added, and increasing FDI inflows and outflows. And, to varying degrees, they enjoyed “catch-up” growth. OECD analysis indicates that those countries and sectors in the BRIICS (Brazil, Russia, India, Indonesia, China and South Africa) that opened up most have enjoyed the largest growth spurts. Export-oriented manufacturing in China, much of it driven by openness to inward investment, is one notable example. The emergence of globally competitive services providers in India, especially in a young, lightly regulated IT sector, is another.<sup>3</sup>

That said, levels of protection in emerging markets and other developing countries on almost all counts – tariffs, non-tariff barriers (NTBs), FDI and services restrictions – remain considerably higher than they are in developed countries. There has also been much less progress on “second-generation” reforms (in behind-the-border trade-related regulations and institutions) than on “first-generation” reforms (mainly border barriers).<sup>4</sup>

### **3. THE GLOBAL ECONOMIC CRISIS, DEGLOBALISATION AND RECOVERY: DIFFERENT EFFECTS ON THE WEST AND EMERGING MARKETS**

THE FINANCIAL CRISIS that exploded in September 2008, preceded by the credit crunch that started a year earlier, transformed a benign global political and economic context into something more malign. A sharp contraction in global growth ensued. This was reinforced by even sharper contractions in trade, FDI, financial flows and other channels of globalisation. The world suffered its worst deglobalisation since the Second World War. Contrary to some predictions, Asia and other emerging markets did not “decouple” from the West; they too were dragged down. Contractions in growth, industrial output and trade bottomed out towards mid-2009, followed by a halting global recovery.

The crisis has induced both *divergence* and *convergence* between the West and emerging markets. Post-crisis economic performance has diverged markedly; but this has accelerated the long-run catch-up or convergence of emerging markets with the West.

Diverging economic performance has its roots in the crisis itself. The West had a financial crisis. That translates into a deeper-than-normal recession and a slower-than-average recovery.<sup>5</sup> The picture looks very different in emerging markets, particularly in Asia. Unlike the West, Asian and many other emerging markets did not suffer a financial crisis; their banks and balance sheets (household, corporate, government and external) were reasonably solid. Rather

they suffered a trade or deglobalisation crisis as the financial crisis, originating in the West, spread to the “real economy” and demand for exports collapsed. But they rebounded quickly – much more so than the West.

China led the Asian bounceback, helping to lift other east-Asian countries out of the crisis, and India recovered fast as well. China and India are expected to grow at more than 10 per cent and just under 10 per cent respectively, and developing Asia at over 9 per cent, in 2010. Brazil and Indonesia are projected to grow at over 7 per cent and 6 per cent respectively. Russia and South Africa are the major emerging-market exceptions: the former had dodgy household and corporate balance sheets going into the crisis, suffered a deep recession in 2009, and is projected to grow at 4 per cent in 2010; the latter is projected to grow at 3 per cent in 2010. Advanced economies are projected to grow at only 2.7 per cent.<sup>6</sup>

Trade volumes for emerging and developing economies suffered a smaller contraction than for advanced economies in 2009, and are enjoying a faster recovery; they are expected to increase by over 13 per cent in 2010, compared with an estimated 10-11 per-cent increase for advanced economies (Table 1). FDI contracted sharply in 2009, with a modest recovery in 2010. FDI inflows to developing countries decreased by 24 per cent in 2009, compared with a 44-per-cent decrease in developed countries (Figure 1). FDI flows to China and India remained buoyant in 2009, generally with a small decline on record inflows in 2008. In contrast, Russia, South Africa, Indonesia and Brazil saw a big contraction in FDI inflows (Table 2). Also, FDI inflows and outflows for these emerging markets look set to increase in 2010.<sup>7</sup>

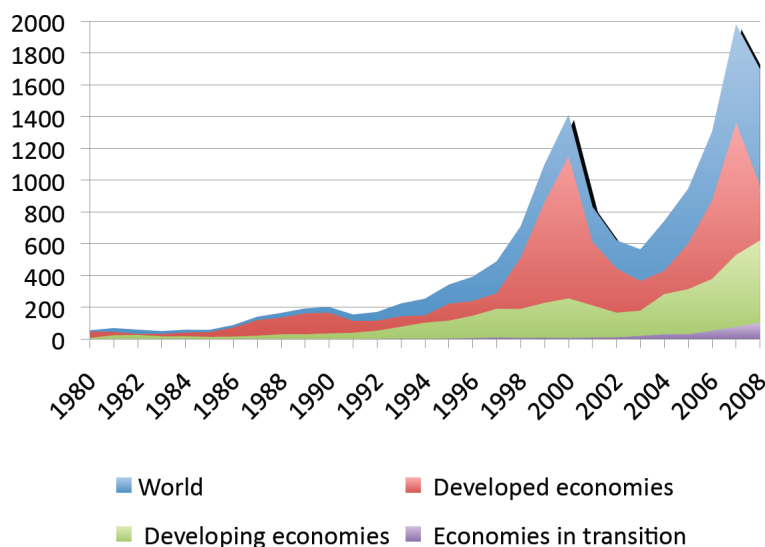
Thus the crisis seems to have accelerated the shift of economic gravity to emerging markets, particularly to the East (i.e. Asia). It has given rise to sunny Asian optimism, which contrasts sharply with Western gloom. There is widespread sentiment that Asia has recovered from the crisis in striking “V-shaped” fashion, just like its recovery from the Asian crisis a decade ago. There is even revived talk of “Asian decoupling”. But that is dangerous Panglossianism; the global economic outlook remains uncertain, probably with turbulent times ahead. That Asia and other emerging markets cannot escape.

**TABLE 1: GROWTH IN WORLD TRADE VOLUME OF GOODS AND SERVICES**

	2008		2009		2010		2011	
	Import	Export	Import	Export	Import	Export	Import	Export
Advanced Economies	0.4	1.9	-12.7	-12.4	10.1	11	5.2	6
Emerging Developing Economies	9	4.6	-8.2	-7.8	14.3	11.9	9.9	9.1

Source: IMF World Economic Outlook, October 2010

FIGURE 1: FDI INFLOWS, GLOBAL AND BY GROUPS OF ECONOMIES, 1980-2009 (USD BN)



Source: UNCTAD World Investment Report 2010

TABLE 2: FDI FLOWS IN MAJOR EMERGING MARKETS

US\$BLN	FDI	2007	2008	2009
<b>BRAZIL</b>	Inflows	34.6	45.1	25.9
	Outflows	7.1	20.5	-10.1
<b>CHINA</b>	Inflows	83.5	108.3	95.0
	Outflows	22.5	52.1	48.0
<b>INDIA</b>	Inflows	25.0	40.4	34.6
	Outflows	17.2	18.5	14.9
<b>INDONESIA</b>	Inflows	6.9	9.3	4.9
	Outflows	4.7	5.9	2.9
<b>RUSSIA</b>	Inflows	55.1	75.5	46.1
	Outflows	45.9	56.1	46.1
<b>SOUTH AFRICA</b>	Inflows	5.7	9.0	5.7
	Outflows	3.0	-3.1	1.6

Source: UNCTAD WIR 2010

#### 4. THE ECONOMIC OUTLOOK: BAD NEWS FOR THE WEST, BETTER NEWS FOR EMERGING MARKETS

WHAT ABOUT POST-CRISIS economic policies in emerging markets and the West? How do they compare?

Even before the crisis, pro-market reforms had slowed down around the world, and there was rising scepticism of the liberalisation-and-globalisation policies associated with the Washington Consensus. Major emerging markets fit this pattern. On the whole reforms were not reversed (Russia is the notable exception), but their forward momentum stalled. Governments became more defensive about further liberalisation; there was marginal liberalisation-reversal. Symptoms included FDI restrictions to protect “national champions” in “strategic”

sectors, and export controls on agriculture and other commodities to combat food and fuel inflation.

The crisis triggered a bigger shift in ideas and policies against free markets and in favour of government interventionism. It marked the close of a thirty-year chapter of freer markets and more limits on government intervention. A new chapter of bigger government has opened.

So far, government interventions have been more evident in domestic economic policy than in trade policy. Domestic “crisis interventions” are bunched in two key areas: huge bailouts and associated subsidies, especially but not confined to financial services; and fiscal stimulus packages, usually combined with loose and unorthodox monetary policies. The former is concentrated in the West; the latter spread across the OECD and developing countries.

Headline fiscal-stimulus measures include the Economic Recovery Act in the United States, releasing initially USD 787 billion of extra public spending,<sup>8</sup> and China’s USD 585 billion package. Fiscal-stimulus packages, i.e. discretionary fiscal spending, amount to about 3.5 per cent of GDP in the OECD.<sup>9</sup> Taking account of automatic stabilisers (the extra demand created by bigger public spending on welfare and other payments in a downturn), fiscal crisis measures amounted to approximately 10 per cent of OECD GDP in 2009. They have been supported by near-zero interest rates, central-bank purchases of government debt and other emergency monetary-policy measures. But financial bailouts have dwarfed macroeconomic interventions. It is estimated that total economic stimulus and financial-sector support amounts to about USD 12 trillion in the United States and USD 18 trillion in the EU. Financial bailouts in high-income countries cost 28 per cent of GDP in 2008 – and close to 75 per cent in the United Kingdom – akin to public financing of a large-scale war.

In China, state-directed bank lending dwarfed direct government stimulus spending. Overwhelmingly, it was channelled through state-owned banks to state-owned industrial firms. It cost about 10 trillion Yuan (USD 1.5 trillion) in 2009, equivalent to about one-third of GDP. However, given solid public finances, this took the fiscal deficit to a modest 3 per cent of GDP, and public debt to about 20 per cent of GDP, in 2009. Most high-income countries are not as fortunate. In the OECD, the average fiscal deficit is estimated to have risen to 9 per cent of GDP in 2009 (even higher in the United States and the UK). US and EU public debt is projected to rise to above 70 per cent and 120 per cent of GDP respectively over the next decade.<sup>10</sup>

The new conventional wisdom holds that massive bank bailouts were necessary to avert financial Armageddon, and so was shock-and-awe fiscal stimulus to boost aggregate demand and stave off another Great Depression. Bank bailouts were unavoidable in the extreme conditions of late 2008. So were extra loose monetary policies to inject a superdose of liquidity, avoiding a repetition of the fatal contraction of money supply in the early 1930s. But it is highly debatable whether massive fiscal pump-priming – Keynesianism on steroids – was necessary. Sceptics doubt the effectiveness of discretionary spending. First, fiscal packages appear to have little effect on GDP; measures often kick in too late or are spent in a way that adds little economic activity. Second, the fiscal multiplier is far from as big as thought by governments, especially in complex open economies (in which some of the extra demand leaks abroad through imports). The multiplier effect of non-defence spending is likely to be far smaller than 1, the level at which GDP expands more than government spending itself.<sup>11</sup> Third, the wreckage of public finances by fiscal stimulus packages is not only a worrying prospect – it is already reality. Recent packages also reinforce unsustainable deficit trends (overall and in social security systems). In the OECD, public debt is projected to reach ab-



surdly high levels in a few years. Oceans of public debt will mean higher taxes and real interest rates, in addition to inflationary threats (given governments' temptation to inflate their way out of debt repayments). Collateral damage will include crowding out of capital for emerging markets, as well as making it more expensive.

The *microeconomics* and *politics* of financial bailouts and profligate macroeconomic policies are at least as vexing. *Bien pensant* policy-makers and commentators -- social engineers in Washington, Whitehall, Brussels and other European capitals, *bona fide* engineers in the Chinese Politburo, "saltwater economists" in US academia, recent Nobel laureates, columnists and editorial writers in the *New York Times* and the *Financial Times* -- think that well-designed government interventions can "fix" market failures in finance and the macroeconomy. That is the *raison d'être* for the return to Big Government since the crisis. But it is stupefyingly naïve to expect intrusive financial regulation and bigger public expenditure to be well-targeted and effective, while avoiding arbitrary interventions, wasteful pork-barrel spending and long-term entitlements. These are all inevitable; they portend more discretionary power for politicians and bureaucrats, indiscriminate subsidies, rent-seeking and corruption. This will stifle private-sector incentives to save, invest and innovate. It will restrict competition and raise costs for businesses and consumers. It will cramp individual property rights and, ultimately, economic freedom. These are likely to be the medium-term consequences of short-term crisis interventions.

This process is already underway. In the United States, in the first year-and-a-half of the Obama administration, it is visible in a battery of microeconomic interventions under cover of the fiscal-stimulus package and other major pieces of legislation and regulatory initiatives, notably on health care, financial markets, industrial relations, antitrust and climate change. In China, fiscal stimulus and state-directed bank lending fortify already subsidised and protected state-owned enterprises (SOEs); they increase SOEs' market and political power at the expense of the unsubsidised (and much more productive) domestic private sector. As the Chinese saying goes, "The state advances while the private sector retreats".

This is tantamount to a halt to, indeed a creeping reversal of, market reforms. It should not be forgotten that one of the engines of the recent era of globalisation and growth was *internal* liberalisation of product and factor markets. That was the hallmark of the Reagan revolution in the USA, the Thatcher revolution in the UK and the Single Market revolution in the EU. New distortions to competition are bound to harm prospects for medium-term recovery and "reglobalisation". That applies generally. But prospects are bleaker in the West than they are in emerging markets. The financial crisis and subsequent crisis interventions have burdened the West with parlous public finances and new restrictions on competition. These will have long-lasting consequences. Major emerging markets -- Russia excepted -- have much healthier balance sheets but retain significant restrictions to competition. Still, their burden is lighter; they are better positioned to recover and reglobalise after the crisis.

## 5. TRADE POLICY, EMERGING PROTECTIONISM AND THE 1970S' PRECEDENT

WILL DOMESTIC CRISIS interventions spill over to trade protectionism? There is an optimistic answer -- and a contrasting pessimistic one.

Start with the optimists. One aspect of the post-crisis conventional wisdom -- dear to the hearts of Keynesian and other social engineers -- is the belief in "Keynes at home and Smith

abroad” (otherwise known as “embedded liberalism” in International Relations jargon). Greater government macro- and microeconomic interventions at home are needed to stimulate recovery and preserve social stability – and thereby prevent a slide into protectionism. But this should proceed in tandem with open markets abroad, which require robust international policy coordination (sometimes labelled “global governance”).

This idea is based on a contradiction. First, Big Government at home, with its discretionary power and panoply of competition-restricting regulations, will inevitably spill over into protectionism. It is childishly innocent to believe otherwise; Keynes at home is Keynes abroad. After all, Keynes turned to protectionism in the 1930s, not least to make activist fiscal policy work in a “closed-economy” setting.

Adam Smith saw this link in the eighteenth century. To him, protectionism is the overspill of government pandering to rent-seeking activity by “merchants and manufacturers”. Thus the “clamorous importunity of partial interests” makes governments lose sight of “an extensive view of the general good.” Hence legislatures should be “particularly careful neither to establish any new monopolies of this kind, nor to extend further those which are already established. Every such regulation introduces some degree of real disorder into the constitution of the state, which it will be difficult afterwards to cure without occasioning another disorder.”<sup>12</sup>

To Jan Tumlrir, the GATT’s long-time in-house philosopher, the source of the problem is overactive governments in cahoots with domestic organised interests. Cumulative interventions distort prices, rigidify economies, and make public and private actors more resistant to adjust to external change. The predictable corollary is a “fear of trade” and the resort to import protection. Thus “protectionism is the inherent logic of the redistributive state working itself out externally.” This is how Tumlrir accounted for twentieth-century protectionism, in the 1920s, 1930s, 1970s and 1980s.<sup>13</sup>

I agree with Smith and Tumlrir. I am more worried about the medium-term competition-restricting consequences of Big Government, including protectionism, than I am about a short-term contraction of aggregate trade and demand in the wake of the crisis.

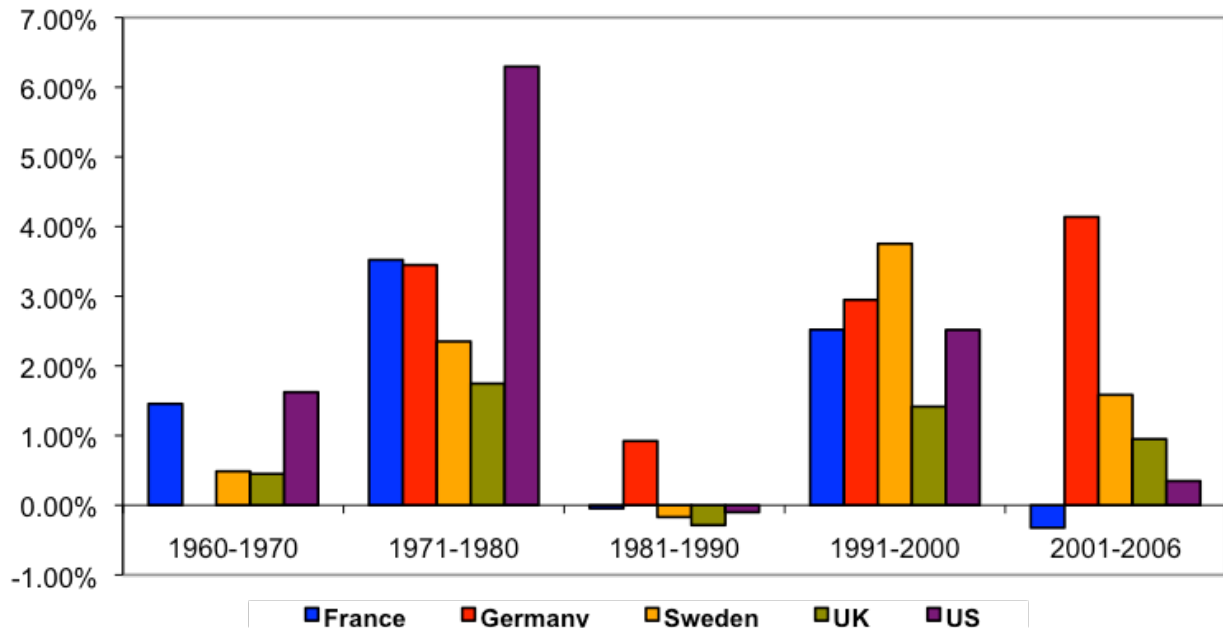
Here historical parallels are in order. It is fashionable to make comparisons between the recent crisis and that of the 1930s. This is appropriate in one sense. Then, a financial crash metastasised into the Great Depression. It also sparked massive government intervention, starting with intrusive and protectionist financial regulations. That caused global finance to fragment into national enclaves. The recent crisis, given its financial origins, has led to a bigger fall in output than in other post-1945 recessions. Recovery will probably take longer. And there is the danger that over-regulation of financial markets will cause global finance to fragment once again.<sup>14</sup> Even so, danger signs today are not as alarming as they were in the 1930s. Global integration of finance is more advanced now than it was then; and post-crisis financial reregulation is shaping up to be much less draconian.

But in one other important respect the comparison with the 1930s is highly misleading. Then, tit-for-tat trade protection rapidly followed the Wall Street Crash, and the world splintered into warring trade blocs. This has *not* happened today, and it is unlikely to happen anytime soon. Up-front crisis-related protectionism today is remarkably restrained (of which more later). Multilateral trade rules, international policy cooperation and market-led globalisation provide defences against a headlong descent into 1930s-style protectionism.

Rather the appropriate comparison is with the 1970s. Then, a series of shocks (notably the collapse of the Bretton Woods system and oil-price hikes) ended a long boom and triggered more government intervention. New labour-market and capital-market regulations were introduced. Subsidies were sprayed at vulnerable sectors. There were fiscal-stimulus packages. Governments slapped on price-and-wage controls to combat inflation. These measures exacerbated initial crises and prolonged stagnation. But they also spawned protectionism: industry after industry, coddled by government support at home, demanded protection from foreign competition. The result was the “new protectionism” and “managed trade” of the 1970s and 1980s.

Voluntary Export Restraints (VERs), Orderly Market Arrangements (OMAs), anti-dumping duties and other mostly nontariff barriers followed bailouts for sectors at home. The USA and the EC were the main culprits. Cars, steel, airlines, semiconductors and consumer electronics were affected.<sup>15</sup> All these measures had a contracting effect on global trade in the 1980s; it became the “lost decade” for trade in the West (see Figure 2). The trade-to-GDP ratio shrunk in major Western economies and contributed to overall slow GDP growth, as also happened across the developing world.

FIGURE 2: ANNUAL AVERAGE GROWTH OF TRADE AS PART OF GDP



Source: World Trade Organisation, International Trade Statistics, database

New Protectionism was *creeping* protectionism. Unlike 1930s-style protectionism, it was not a frontal declaration of a trade war with tariff hikes, blanket quotas and draconian foreign-exchange controls. Rather it was more subtle, deploying non-tariff regulatory barriers such as subsidies, public-procurement restrictions and onerous standards requirements. It did not spiral out of control; rather it unfolded slowly and insidiously, and lasted over a decade-and-a-half. It created overcapacity in several industrial sectors, and delayed global recovery and globalisation. That, not a melodramatic 1930s scenario, is the danger facing us today.

This 1970s scenario needs two qualifications, however – both related to today’s China-led emerging-market phenomenon. First, the New Protectionism of the 1970s and 80s was large-

ly a Western response to new competition from Japan and four other relatively small east-Asian emerging markets (South Korea, Taiwan, Hong Kong and Singapore). Today, competition from emerging markets is much more intense and more geographically spread out. Competition in manufactures still comes from east Asia, now revolving around China, but Brazil, India and other emerging markets are adding to global competition in agriculture and services as well. That strengthens complementary trade-and-investment linkages, especially through vertically-integrated supply chains, but it also increases protectionist temptations in vulnerable sectors.

Second, there is much talk today about “global imbalances”, the spectre of “currency wars” and their spillover to trade protectionism. China, Japan, Germany and the petro-states of the Middle East account for massive current-account surpluses, mirrored by sizeable current-account deficits elsewhere, especially in the USA. US complaints about an allegedly grossly undervalued RMB and persistent Chinese current-account surpluses have become shriller. China stands accused of protectionism via “currency manipulation”, which, it is said, constitutes an export subsidy. Via its current-account surplus, China is charged with adding to global imbalances at a time when Western demand is depressed, and when the USA in particular is attempting a shift from consumption to savings. Other countries succumb to the temptation of devaluing their currencies; a round of competitive devaluation ensues. This is the prelude to “currency wars”, which in turn threaten a new round of trade protectionism.

The US House of Representatives has passed a bill to slap trade sanctions on China as retaliation for its currency manipulation. Fred Bergsten, Paul Krugman, Martin Wolf and other luminaries have called for trade or capital-market sanctions if China does not fall in line. Ahead of the G20 summit in Seoul, the US proposed “numerical targets” (of +/- 4 per cent of GDP) to limit current-account imbalances.<sup>16</sup>

Large and persistent currency undervaluation and current-account surpluses, especially for a country as large and as important as China, can perhaps be a source of global instability, and indeed exacerbate protectionist pressures. One is reminded of the currency wars of the 1930s (some countries stayed on the gold standard while others left it), which triggered more trade protectionism than the Smoot-Hawley tariff.<sup>17</sup> But today the spectre of currency wars has not triggered a new round of protectionism – so far. And the negative consequences of currency undervaluation and current-account imbalances are probably – perhaps vastly -- exaggerated.

Conventional American reasoning on this set of issues has deep flaws, with dangerous policy inferences. The RMB may be undervalued, but no one knows what the “right” market exchange rate is or should be, and estimates of undervaluation range from 0-50 per cent. An obsession with nominal exchange rates is also misleading. The assumption of a straightforward, mechanical translation from an undervalued currency to a current-account surplus is highly questionable, *especially* in China’s case. “Processing trade” (imports of raw materials and components for assembly and export of finished goods all over the world) accounts for half of China’s overall trade – and blunts the effects of currency swings. A large and sudden RMB revaluation could be very destabilising for the Chinese export economy, without making a corresponding dent into the US current-account deficit (given that US production is highly unlikely to substitute for Chinese labour-intensive exports). American consumers and firms who use Chinese inputs would suffer through higher prices.

Underlying economic policies relating to savings, investment and consumption probably have a greater effect on external imbalances than exchange rate valuations. So do other

structural factors. China's "double transition" – rural-to-urban migration and fast-paced industrialisation, combined with a condensed demographic dividend (a large increase in the working-age ratio, speeded up by China's one-child policy) – gives it huge, long-lasting comparative advantage in labour-intensive exports. Since the 1990s, this has been accompanied by a reorientation of production and trade in global supply chains, as China has become the premier assembly hub for manufactured exports. Via processing trade, China runs deficits with other east-Asian countries and surpluses with Europe and the USA. Correspondingly, other east-Asian countries have seen their trade surpluses increase with China and decrease with the West. All this suggests that most of China's trade surplus – the biggest chunk of its current-account surplus – is not the result of "unfair trade"; rather it results from modern, thoroughly "normal", global integration. Which makes one wonder: is an obsession with national current-account imbalances warranted in a world of 21st-century globalisation characterised by processing trade and vertically-integrated global supply chains?<sup>18</sup>

A Chinese move to *gradually* revalue the RMB alongside domestic structural reforms might ease global imbalances and protectionist pressures – though large imbalances will persist for the normal, structural reasons mentioned above. But the American obsession with the RMB and the Chinese current-account surplus is both misguided and dangerous. Its analysis belongs to a world that predates modern globalisation, and its headline prescriptions (trade and/or capital-market sanctions) are crudely mercantilist.

## EMERGING PROTECTIONISM

AT FIRST GLANCE the Keynesian optimists, not the Smithian pessimists, are right: the world has not hurtled into tit-for-tat protectionism. That is a big and very welcome surprise, given the scale of growth contraction and deglobalisation in 2008/9.

The good news is documented in WTO updates on new trade measures. New protectionist measures have appeared – what the WTO refers to as "policy slippage" – but they are remarkably mild. They affect just over 1 per cent of world trade in goods (1.2 per cent of world imports and 1.8 per cent of G20 imports at the last count), and protectionism in trade in services has not increased noticeably. New protectionism is concentrated in sectors that have long been protected: textiles, clothing, footwear, iron, steel, consumer electronics and agriculture. Trade remedies increased in 2009, as they do in economic downturns, but declined again in 2010. Finally, up to one-third of new trade measures have been *liberalising*; these include tariff reductions, removal of export restrictions and FDI liberalisation in several developing countries.<sup>19</sup>

One caveat: The WTO focuses on established and commonly understood trade instruments covered by WTO disciplines, especially import and export tariffs, quotas and licenses, and trade remedies. It notes a range of non-border measures such as government-procurement restrictions, technical standards and potentially trade-distorting subsidies. But it does not take a stand on financial bailouts, saying that their discriminatory impact on international trade is still unclear.

*Global Trade Alert* (GTA) paints a more alarming picture. It counts nearly 650 trade-discriminatory measures from November 2008 to June 2010; G20 governments are responsible for just over 60 per cent of these measures. GTA estimates that twenty-two far-reaching protectionist measures alone affected over 10 per cent of world imports in 2008. Unlike the WTO, GTA includes financial bailouts. By November 2009, it estimated that one-third

of new protectionist measures were bailouts to financial services, automobiles and other sectors. Trade remedies accounted for one-fifth and tariffs 14 per cent of new protectionist measures. China remains the biggest target, followed by the EU 27 and the United States. No other emerging market figures in the list of top 10 targets (Table 3). Russia is probably the worst single offender, with a significant increase in protection since the crisis started. The EU 27, though, tops the list in terms of the number of new protectionist measures imposed. Argentina, China, India and Indonesia – but not Brazil and South Africa – also figure in the list of top 10 offenders (Table 4).<sup>20</sup>

**TABLE 3: COUNTRIES TARGETED BY CRISIS-ERA TRADE-RESTRICTIVE MEASURES**

Target	Number of discriminatory measures imposed on target		Number of pending measures which, if implemented, would harm target too	
	November 2010	Increase since June 2010	November 2010	Increase since June 2010
China	337	55	129	4
EU27	322	56	88	8
USA	260	47	51	5
Germany	240	36	63	7
France	221	33	50	4
UK	214	33	48	4
Italy	211	36	53	3
Japan	192	24	50	4
Netherlands	191	21	45	3
Belgium	189	19	46	3

Source: Global Trade Alert (2010): *The 8th GTA Trade Report*, CEPR, London, [http://www.globaltradealert.org/sites/default/files/GTA8\\_0.pdf](http://www.globaltradealert.org/sites/default/files/GTA8_0.pdf)

**TABLE 4: CRISIS-ERA TRADE-RESTRICTIVE MEASURES BY COUNTRY**

Rank	Ranked by number of measures	Ranked by the number of tariff lines affected by measures	Ranked by the number of sectors affected by measures	Ranked by the number of trading partners affected by measures
1	EU27 (166)	Viet Nam (926)	Algeria (67)	Argentina (174)
2	Russia (85)	Venezuela (785)	EU27 (57)	EU27 (168)
3	Argentina (52)	Kazakhstan (723)	Nigeria (45)	China (160)
4	India (47)	Nigeria (599)	Venezuela (38)	Indonesia (151)
5	Germany (35)	Algeria (476)	Viet Nam (38)	Algeria (476)
6	Brazil (32)	EU27 (467)	Germany (36)	India (145)
7	UK (31)	Russia (426)	Kazakhstan (36)	Russia (143)
8	Spain (25)	Argentina (396)	Russia (36)	Finland (132)
9	Indonesia (24)	India (365)	India (32)	Germany (132)
10	Italy (24)	Indonesia (347)	Ethiopia (32)	South Africa (132)

Source: Global Trade Alert (2010): *The 8th GTA Trade Report*, CEPR, London, [http://www.globaltradealert.org/sites/default/files/GTA8\\_0.pdf](http://www.globaltradealert.org/sites/default/files/GTA8_0.pdf)

Summing up, the good news on remarkably mild “traditional” protectionism (mainly border barriers) is balanced by worrying signs of non-traditional, non-border protectionism.

“Financial mercantilism” is at the top of the latter list. One aspect of it is home-government pressure, whether formal or through nods and winks, on bailed-out and other banks to “lend local”, i.e. to lend at home at the expense of foreign lending (e.g. through foreign subsidiaries). Cross-border lending has shrunk during the crisis, e.g. by west European banks in eastern Europe, but the extent to which this is the result of home-government pressure is unclear. A second, related aspect of financial mercantilism is pressure from home governments and regulators to concentrate more financial trading activities at home, with accompanying restrictions on cross-border trade. One example is an EU directive that requires non-EU-based private-equity and hedge funds to establish physical presence in the EU in order to trade. Finally, regulatory proposals in the United States, EU and elsewhere may end up with a cordon sanitaire around mammoth banks deemed “too big to fail”, with alarming implications for global competition as well as moral hazard.

Financial mercantilism is clearly a “work in progress”; it is too early to judge its protectionist impact. But it has potential to escalate and cause great harm. It threatens the renationalisation and fragmentation of global finance, which would damage market globalisation generally, and with it the welfare of rich and poor countries.

There are several other non-traditional protectionist instruments deployed in the wake of the crisis: industrial subsidies, restrictions on migrant workers, FDI restrictions, and standards.

First, industrial subsidies. These have gone overwhelmingly to the automobile industry in the United States and the EU. In China, they have been sprayed more liberally at SOEs in several capital-intensive sectors. In the OECD, subsidies to auto firms have been in the form of direct support and “scrappage” schemes (subsidising the trading in of old cars for new ones). In the OECD and China, direct support has gone to domestic firms and could well fall afoul of WTO disciplines on trade-distorting subsidies.

Second, public-procurement or “buy-national” restrictions. The headline examples are the “Buy American” provisions in the US fiscal-stimulus package and the seemingly retaliatory “Buy Chinese” provisions in China’s fiscal-stimulus package, which spread to many Chinese provinces.

Third, restrictions on migrant labour in both developed and developing countries. The United States, for example, has restrictions on H1B visas for foreign nationals working in bailed-out banks. There is no equivalent measure in the EU, but labour migration to the EU has fallen significantly, and some governments have resorted to “local-jobs-for-local-workers” rhetoric (as was the case in the UK).

Fourth, FDI restrictions or “investment nationalism”. This has not been a major global problem so far. New FDI restrictions are bunched in energy-related sectors. There are North American, European and Australian anxieties about emerging-market sovereign-wealth funds and the overseas expansion of SOEs, particularly from China. Chinese FDI restrictions have clearly increased in the last few years. But UNCTAD notes that 70 per cent of new FDI measures were liberalising in 2009, though this is below the trend between 1992 and 2004 (when 92.5 per cent of investment measures were “more favourable” to FDI).<sup>21</sup>

Fifth, standards protectionism. Anecdotal reporting points to more restrictive application of technical and food-safety standards on imports since the crisis started. China banned several European agricultural products. India imposed tighter standards on imports of iron, steel, yarn, soyabean oil and aluminium, in addition to import bans on Chinese toys, cellphones and poultry. Indonesia imposed pre-shipment inspection requirements on over 500 goods, which could only enter through 6 seaports and all international airports.<sup>22</sup> The WTO also notes a marked increase in TBT (technical barriers to trade) notifications in 2008/9.<sup>23</sup> These are all areas in which officials have considerable discretionary powers. It is predictable that they would use this leeway to tighten the screws on imports in a severe economic downturn.

The climate-change agenda is set to be the Trojan Horse of new standards protectionism. The EU already has an emissions-trading scheme. Equivalent schemes were working their way through US and Australian parliaments, but are now stalled. Because such cap-and-trade schemes will impose substantial compliance costs on energy-intensive sectors at home, there will be more pressure to impose similar costs on cheaper, carbon-intensive production elsewhere not subject to carbon-reduction policies. Hence the spectre of trade sanctions on “free riders” – China in particular. Retaliatory threats revolve around “border tax adjustments”, i.e. tariffs on carbon-intensive imports. But climate-change protectionism could include “green subsidies” that discriminate in favour of domestic renewable-energy providers, and all sorts of discriminatory standards. The EU, for example, has a technical regulation in its Renewable Energy Directive that insists on a 35 per-cent saving on greenhouse-gas emissions from bio-fuels entering the EU market. Effectively, this discriminates in favour of French and Spanish producers of rapeseed oil at the expense of cheaper east-Asian competition.<sup>24</sup>

Predictably, the WTO and G20 have been quick to claim credit for restraining traditional protectionism. That does not ring altogether true. G20 pledges not to increase protectionism have been violated “every other day” by its members.<sup>25</sup> WTO disciplines may, at the margin, have restrained border protectionism by OECD members and newly-acceded members like China and Vietnam, given strong GATT disciplines on tariffs and other border barriers. But they have certainly not restrained most developing countries’ protectionism, even on tariffs. Most developing countries have high bound tariffs in the WTO, and they could quite legally raise applied tariffs much higher than they have done.

There is something else at work. The credit for restraining traditional protectionism should go in the first instance to *markets* and *globalisation*, and only in the second instance to multi-lateral trade rules, international policy coordination and assorted summitry in the G20 and other international fora. Global market integration has imposed *spontaneous* disciplines on governments and businesses. They realise that up-front protectionism raises business costs, invites retaliation, excludes them from the benefits of globalisation, and damages wealth and welfare at home. That applies particularly to global supply chains. Take manufacturing supply chains with production centred in east Asia. They suffered disproportionately from trade contraction in the first six months of the crisis. But protectionism did not increase in these sectors; and supply chains remained intact, ready for the upturn that followed.

More worrisome is the non-traditional regulatory protectionism in the pipeline, especially on subsidies and standards, on which WTO disciplines are weak-to-non-existent. These measures are not covered by the Doha agenda. Given the parlous state of WTO negotiations, it will be a long time before the WTO strengthens rules on subsidies, FDI, government procurement, cross-border movement of labour and standards – if it ever happens, that is. These measures are more opaque than border-based protection; governments and organised inter-



ests may well resort to them more frequently, not least to evade existing WTO disciplines. The danger is that, if not contained, they will spread gradually to cover bigger swathes of international trade. That is the 1970s scenario to worry about.

To sum up the global policy outlook: The medium-term consequences of the financial crisis and domestic crisis interventions are likely to be far worse in the West than in emerging markets. The prevention of traditional protectionism is good news all-round. Equally, creeping non-traditional protectionism is worrying news all-round.

## 6. A REVIEW OF THE TROOPS

NOW TURN TO the major players in trade policy and see how they have responded to the crisis. This section starts with the United States and the EU, and then goes on to the major emerging markets and Japan.

### UNITED STATES

AMERICA IS DOWN and diminished, though not out. On foreign policy, President Obama's rhetoric on soft power and multilateralism has not translated into effective American leadership abroad, on either security or economic agendas. Economic woes at home clearly cramp the USA's ability to lead abroad; weakness at home translates into weakness on the global stage.

Trade policy has deteriorated in the United States since the Obama administration took over. The Bush administration, for all its faults, did not do a bad job on this front. Its major achievement was to contain protectionism at home, especially against China. President Obama, on the other hand, while no clear-cut protectionist, has ambivalent views on the subject and is not an instinctive free-trader. He has powerful protectionist forces inside his tent – among Congressional Democrats, the AFL-CIO, and at his Cabinet table. The Office of the United States Trade Representative is packed with staffers with close links to trades unions as well Congressional lawmakers with protectionist voting records. This makes the Obama administration different from previous administrations, including the Clinton administration.

President Obama's record to date shows a balancing act, giving way to domestic protectionist forces at one moment, but cushioning their impact and maintaining open markets the next moment. The Buy American provisions in the fiscal stimulus package passed by Congress were modified to make them compatible with the WTO's Government Procurement Agreement. The President agreed to impose anti-dumping duties on Chinese tyre imports; but six weeks later he announced that the United States would negotiate to enter the Transpacific Partnership, a free trade agreement with six other Asia-Pacific countries. He has not given into Congressional pressure to label China a "currency manipulator".

The administration's overall approach is defensive; and trade policy is very low down its list of priorities, indeed crowded out by domestic priorities. Above all, the administration is *not* leading with open-market initiatives. It has done nothing to finish the Doha Round, and only belatedly (after the Republican victory in Congressional mid-term elections) has it renegotiated the FTA with South Korea and tried to get already negotiated FTAs with Panama and Peru ratified by Congress. Its main emphasis is on better enforcement of trade laws to ensure foreign access for US exports, with the announced goal of doubling US exports in five years. Overall, the President seems extremely disinclined to face down his union supporters

and protectionists in the Congress. That is no surprise: a left-liberal administration given to domestic intervention left, right and centre is not the sort of administration to take the fight to protectionists at home and lead international cooperation to open markets worldwide. Finally, open-market constituencies in American business have been muted; and relations between the administration and leading business associations (especially the US Chamber of Commerce) soured through 2009 and 2010.

This is bad news. For all President Obama's sweet-sounding multilateralist rhetoric, he has no substantive trade policy; the United States is abrogating its traditional leadership role in world trade. That leaves the field open to creeping protectionism in the United States, a deterioration of key bilateral trade relationships (especially with China), and continued weakening of the WTO. It also leaves a global vacuum, for there is no substitute leader to forge international cooperation to contain protectionism, open markets and strengthen multilateral rules – not the EU, not China, not anyone else. The United States may be diminished in the wake of the crisis and in the face of rising powers, notably China; but it is still the fulcrum of international relations. No rising power is in a position to exercise the kind of global leadership the United States has exercised since 1945.

## EU

THE PICTURE IN the EU is similar to that in the United States: internal weakness and external defensiveness.<sup>26</sup> True, some European economies show signs of healthy recovery. But that is not the overall picture. Symptoms of *malaise* abound: sovereign-debt crises, still-malfunctioning banking systems, industrial strife, sclerotic labour markets, bloated welfare states, intergovernmental squabbling and weak EU institutions.

The EU has behaved better than most in terms of headline protectionist measures. It has not increased tariffs, nor – unlike the Americans and Chinese – has it resorted to discriminatory public-procurement measures. And there has been no significant increase in anti-dumping actions and other “trade remedies”. But worrying signs persist. They concern crisis-related regulatory measures that could easily spill over into protectionism. The relaxation of EU state-aid rules during the crisis opened the door to discriminatory subsidisation, especially to the financial and automotive sectors. The EU already has the most stringent food-safety and technical standards in the world. These could become more restrictive, especially on environmental and climate-change regulations. Indeed, “green protectionism”, mainly through discriminatory subsidies and standards, is more of a threat in the EU than anywhere else in the world.

EU defensiveness is the main danger. Generally, when the Single Market is opening up and integrating, EU trade policy is more outward-looking and proactive. That was the case in the 1990s. When the Single Market is under stress from internal protectionism, EU trade policy turns to navel-gazing and gives way to protectionism against outsiders. That happened in the 1970s and '80s. And that is roughly the situation today.

Perhaps the biggest casualty of the crisis was the abandonment of the Lisbon Agenda of market reforms to boost EU competitiveness. Now the EU has a “2020 strategy”. But it is unambitious, vague in parts, and with hints of soft industrial-policy activism (e.g. centralised targets for R&D spending); hard market liberalisation and concrete structural reforms are missing. Externally, trade policy is defensive. Trade negotiations are not advancing or stuck. That is the case with the WTO's Doha Round, Economic Partnership Agreements with African,

Caribbean and Pacific countries, and bilateral negotiations with several countries in Asia, the Middle East and Latin America. Trade relations with China are also adrift and replete with tensions. The exceptions to this rule are the freshly ratified FTA with South Korea, and ongoing negotiations with Canada, Singapore and India. And the EU's vaunted "soft power", outside its immediate neighbourhood, is hardly taken seriously – when not dismissed as a joke. The European Commission's new trade strategy, announced in November 2010, does nothing to change these facts on the ground, rather being an update and slight modification of established policy.<sup>27</sup>

Finally, the EU suffers from a paradox. With enlargement and greater market size it is weightier in the global economy. But at the same time its decision-making has become more fragmented, making it more difficult to coordinate national positions and speak with one voice. That decreases its ability to wield collective power abroad. In the one arena where the EU is a global heavyweight -- trade policy -- competence has been divided on several issues, notably services and investment. An enlarged EU made it extra-difficult to have credible positions in international negotiations on services and investment. The Lisbon Treaty is supposed to overcome these problems by streamlining decision-making and unifying competence on services, investment and intellectual property rights. But this is counter-balanced with "co-decision" for the European Parliament. That confers the EP greater power in EU trade policy. Market-sceptical forces and single-issue fetishists in the EP are bound to complicate decision-making and could tilt policy outcomes in a more protectionist direction.

## CHINA

CHINA HAS POWERED through the crisis with a turbo-charged fiscal and monetary stimulus equivalent to almost 45 per cent of GDP in 2009. It is the leading contributor to post-crisis global growth. Other countries around the world export raw materials and capital goods to power China's continuing industrial revolution. That is also true of other east-Asian economies, who, in addition, export parts and components to China for assembly and export elsewhere. Increasingly, they are also gearing up to export finished goods to a booming Chinese consumer market. More than ever, the rest of Asia revolves around China.<sup>28</sup> Gradually, China is asserting itself in international organisations. And its footprint is ever-more visible elsewhere in the non-Western world – in its east-Asian backyard, and in south Asia, Africa and South America.

China is now one of the Big Three in the global economy. Until recently, it imported "global order": it absorbed policies, rules and institutions that materialised from decisions made elsewhere. China still imports global order; but, given its market size, and like the USA and EU, it now exports global order as well. Decisions made in China reverberate around the world. And they do so to a much, much greater extent than decisions made in the other BRICS. China accounts for about 60 per cent of BRICS' output, two-thirds of its foreign-exchange reserves and exports, and one-third of its inward investment. China plays in its own league among emerging markets. The other BRICS play in an inferior league; they are still much bigger net importers of global order.<sup>29</sup>

But that is still a far cry from Chinese "leadership", let alone notions of "China ruling the world".<sup>30</sup> To assert the contrary is China hype. While China has just overtaken Japan to become Asia's largest economy, it is still far behind the USA (at market exchange rates); and its living standards are less than a fifth of the US average (at purchasing-power parity). China's military spending, while growing at double-digit rates, is still only a tenth of US military spending.

On trade policy, there has been paltry unilateral liberalisation going beyond China's WTO commitments – largely confined to marginal liberalisation of the securities market and baby steps to internationalise trading of the renminbi. Indeed, liberalisation has stalled since about 2006, corresponding with more industrial-policy measures to promote selected domestic sectors.<sup>31</sup> The already complex export regime, comprising tariffs, bans, tax rebates, licensing and quotas, has become considerably more restrictive. Tax incentives, subsidies, price controls, as well as administrative “guidance” on investment decisions, are used to favour domestic sectors over imports, especially in capital-intensive sectors where state-owned enterprises (SOEs) and assorted “national champions” operate. Unique national technical standards, e.g. for 3G mobile phones, have been promoted. Legislation and “guiding opinions” have enlarged the basket of goods and services sectors in which foreign investment is banned or restricted. The Antimonopoly Law, effective from August 2008, contains vague language on the “public interest”, “national economic security” and “unreasonable” prices, and no definition of market dominance. It has sweeping exemptions for SOEs, but can be used as a tool for greater control of MNEs. Internet censorship has increased, affecting foreign technology companies such as Google. Recently, MNEs have been most worried about China's “indigenous innovation” policies that aim to promote domestic technology companies. Regulatory measures potentially include discriminatory public procurement and intellectual-property restrictions (such as compulsory technology-transfer in return for market access).

Such trade- and industrial-policy measures deepen China's entrenched domestic weaknesses. Growth continues to rely on high rates of domestic saving and investment, but at the expense of repressed domestic consumption. Factor markets (for land, capital, water and energy) remain tightly controlled. *Dirigiste* policies favour polluting, capital-intensive industrial SOEs, state banks in a backward financial system and capital markets, and monopolistic services providers in other sectors. Externally, surplus savings and an undervalued exchange rate contribute to global economic imbalances and generate extra trade tensions.

“Rebalancing growth” – making it more consumption- and less investment-driven – requires deep competition-enhancing reforms. These range from public-sector and financial-sector reforms to secure private property rights, deregulation of internal trade, market pricing for resource inputs, and better provision of health, education, pensions and social security. Market liberals would also like to see “WTO-plus” trade and FDI liberalisation: reversal of export restrictions and import-tariff reductions; limits to industrial-policy activism through discriminatory standards, subsidies, internet and foreign-investment controls; less regulatory discretion and more transparency in trade procedures; better enforcement of intellectual property rights; accelerated services liberalisation; and liberalised markets in government procurement and energy.

These reforms cannot be done quickly – and certainly not in a top-down style global agreement like the Plaza Accord in the 1980s to depreciate the US dollar. Needed reforms revolve around factor markets; they go to the heart of the Communist Party-government-public sector nexus and its grip on power. Politically, this is much harder than liberalising product markets – the thrust of Chinese liberalisation to date. Major structural reforms to liberate factor markets are unlikely to happen soon. Indeed, China's crisis response – essentially an investment binge – bolsters the public sector and state power at the expense of the private sector. It has succeeded in arresting growth slowdown in 2009, but it exacerbates China's structural fault-line of over-investment and under-consumption. Its command-and-control mechanisms take market reforms backwards. And there remains the risk of surplus manu-

facturing capacity flooding into shrinking export markets in Europe and North America, thereby inviting protectionist retaliation against China.

Commendably, a pragmatic Beijing leadership has not rocked the boat during the crisis: it has not resorted to aggressive mercantilism. Direct protectionist responses to the crisis have been quite restrained. And recent trade conflicts with the United States and EU over internet censorship, export restrictions, “indigenous innovation” policies and the exchange rate should not be exaggerated: they do not amount to a trade war. Protectionism has been heavily constrained by China’s already deep integration into the global economy, particularly through manufacturing supply chains, and by its strong WTO commitments. But stalled trade and FDI liberalisation, the absence of domestic structural reforms and creeping protectionism threaten future trade tensions.

Overall, China’s domestic weaknesses will cramp its ability and will to lead externally. Its leaders will remain too preoccupied with China’s myriad economic, political and social problems to switch to external leadership mode. This context also diminishes China’s ability to look outward and exercise leadership in the world economy. Besides, China has no tradition of regional or global leadership.

China hypes would have us believe that China will be taken over by “state capitalism”; that it will decouple from the West and switch to domestic consumption; that it will be militarily aggressive and dominate Asia; and that it will exercise global leadership.<sup>32</sup> None of the above is likely to happen anytime soon. China remains a complex hybrid; it still presents a very mixed political and economic picture.

## JAPAN

JAPAN IS STILL about as large as China in absolute market size, and is still Asia’s richest economy (in terms of per-capita income). But it is stuck in a political and economic quagmire that has lasted two decades. The Japanese political system is blocked; it seems hopelessly incapable of delivering clear policy choices, including economic reforms. The economy has sputtered along a low-growth track, now with astronomically high public debt. The crisis seems to have made Japan even more averse to reform. Exceptionally in Asia, Japan has had a Western-style crisis: Keynesian macroeconomic policies alongside escalating public debt; and growth contraction followed by modest recovery. Conditions would be much worse if not for roaring growth in its neighbourhood, especially in China.

These factors play into Japan’s passive and reactive trade policy. It has stayed on the sidelines of the Doha Round, rather focusing on bilateral FTAs and regional-integration initiatives in east Asia. But its FTAs are mostly “trade-light” and its regional-integration initiatives half-baked.

Overall, Japan seems condemned to be a dwarf on the global stage. That and historical baggage prevent it from becoming a regional leader. Now, China’s political and economic ascent casts an ever-longer shadow over Japan. At best it can be a second-rank or upper-middle power in Asia, perhaps alongside India.

## INDIA<sup>33</sup>

INDIA HAS WEATHERED the crisis well, buoyed by exuberant domestic consumption. Previous market reforms, especially since 1991, have liberated domestic producers and consumers,

and opened India to the world. Trade and FDI liberalisation has been critical to India's recent global economic integration. Internal and external market reforms have transformed the business landscape and spawned an aspiring, vibrant urban middle class. But relatively high levels of protection remain: agricultural tariffs and NTBs, peak industrial tariffs and big-ticket services sectors (such as professional services, banking, insurance, retail and distribution, and aviation).

India's trade and FDI liberalisation has come about almost totally through unilateral measures. But this has not translated into much greater flexibility in the WTO. India's GATT and GATS commitments are weak. It is a lead player in the Doha Round, but remains defensive, especially in agriculture and industrial goods. India has become very active with FTAs, but this is mostly about foreign policy and is very trade light. It also has very high and largely unreformed domestic regulatory barriers. These include draconian employment laws, reserved sectors for small-scale industries (though this list has been reduced), high and differing barriers in the states (India being a federal system), extremely interventionist agricultural policies (subsidies, price controls and other internal trade barriers), domestic restrictions on services sectors, huge subsidies and price controls on energy, lack of rural property rights, and very inefficient, corrupt public administration. Public-sector reform has hardly begun.

India's response to the global economic crisis was fiscal-stimulus packages amounting to about USD 60 billion – though, unlike China, in the context of deteriorating public finances, with the consolidated fiscal deficit climbing to above 10 per cent in 2009. Protectionist measures have increased, though not in a major way. Higher import tariffs, licensing requirements, provisional AD duties, safeguards and tighter standards restrictions were applied in selected sectors, much of it targeting Chinese imports; but they did not affect a big chunk of India's trade.

The May 2009 election delivered an unexpectedly strong mandate to the Congress-led government; India has its most stable government in over twenty years. But this has not led to a new wave of market reforms. Reforms have stalled since Congress came to power in 2004, and there are no signs of big change. Dr. Singh and his “dream team” have proved bogus, not genuine, reformers in the past six years; and anti-market sentiment and vested interests remain strong in the Congress Party.<sup>34</sup> The opposition BJP has lost the reform impulse it had in government and is in disarray. Trade policy remains a combination of stalled unilateral liberalisation, defensiveness in the Doha Round and trade-light FTAs.

Nevertheless, a combination of stable government and roaring growth gives rise to exuberant optimism. India boosters claim that growth will soon exceed 8-10 per cent per annum; its catalysts will be high-value services and manufacturing niches; and this can happen without a new wave of policy reforms. At the same time, they argue, India is rising to be a regional and global power.

This is India hype -- even more ridiculous than China hype. It defies belief that India can boost growth above an annual 10 per cent without further structural reforms. In terms of market reforms, India lags behind China and other parts of east Asia. It has higher protection against imports and inward investment. Its public finances, infrastructure and lower-education system are much weaker. It has more damaging restrictions that stymie domestic markets in agriculture, manufacturing and services – especially draconian employment laws that prevent firms from employing unskilled workers in large numbers. Government subsidies are more wasteful. Worst of all, India's unreformed, dysfunctional state – the Union government in Delhi, the state governments and other levels of government – is the biggest

obstacle to faster growth. Growth has come from capital- and skill-intensive sectors in manufacturing and services. It has primarily benefited the urban well-to-do and middle classes, but not flowed down as much as it has in east Asia to the poor in the rural areas – the bulk of India’s population.

Absent further market reforms, India will not have what it desperately needs: east-Asian-style, labour-intensive agricultural, services and industrial growth. In particular, India needs its Industrial Revolution so that the impoverished in the countryside can move to (initially) low-wage work in mass manufacturing.<sup>35</sup> That has yet to happen. And it demands regulatory reforms – not least in labour markets and the public sector – that remain politically very hard nuts to crack. Moreover, the combination of a barely-reforming government in Delhi and worse global economic conditions after the crisis might make it difficult to maintain current levels of growth.

No one can deny that India is a bigger player on the global stage. But, economically and militarily, it is still too small to be a pan-Asian, let alone a global, leader. It pales in comparison with China. Even within south Asia its leadership is diminished by testy relations with most of its neighbours, and disastrous relations with its biggest neighbour, Pakistan.

## BRAZIL<sup>36</sup>

BRAZIL’S BIG OPENING after half a century of high protectionism started in the late 1980s. Liberalisation through the 1990s has resulted in a relatively open market for FDI and services; it is noticeably more open to FDI than Russia, India and China. It now has a diversified export basket, ranging from crude oil and processed minerals (such as petroleum products, coke and ethanol) to metals, chemicals, rubber, plastic, agricultural commodities, food-and-beverage products and manufacturing. That said, there are still relatively high tariffs on imported intermediate products that keep local production costs high, and equity limits and other restrictions on FDI, notably in banking, oil, mining and air transport.

Brazil has been a lead player in the Doha Round, especially through its leadership of the G20 in agriculture; and it has been active in dispute settlement, winning landmark cases against the USA on cotton and the EU on sugar. Brazil is also the south-American hub for bilateral and regional trade agreements. Mercosur is at the heart of this network, but it is a relatively weak customs union with several exceptions to its common external tariff and very little progress on NTBs, services and investment. Mercosur has several FTAs with third countries; and Brazil has stepped up FTA activity with developing countries outside the Americas. These are mostly very trade light, amounting to fixed preferences on a limited range of tariff lines.

Overall, Brazil relied on unilateral trade-and-FDI liberalisation to open the economy. Since 1994, trade negotiations – bilateral, regional and multilateral – have almost totally substituted for unilateral liberalisation, but they have delivered virtually zero liberalisation. Many business voices complain that Brazil’s WTO and FTA activity is geopolitics-driven and lacks commercial sense. Its accommodation of India in the G20 has compromised its agricultural exporting interests; and defensiveness in NAMA negotiations does not reflect Brazil’s export strength in industrial goods. Also, its new FTAs are with countries such as South Africa and India with which it does relatively little – though fast-increasing -- trade, while it has deprioritised existing FTA negotiations with two of its three most important trading partners, the USA and EU.<sup>37</sup>

Brazil domestic regulatory barriers are very high – roughly in the ball park of India, Indonesia and Russia. Opening and closing businesses, labour markets, pensions, public administration and the tax regime are particularly burdensome. The Lula administration has pursued centrist economic policies: it has not intervened heavily in the economy, but it has a penchant for occasional industrial-policy interventions to promote selected sectors. At the same time, it has eschewed further external liberalisation and domestic structural reforms. The accent on industrial policy could become stronger when Brazil exploits its new oilfields.

Brazil has weathered the crisis well and hardly raised protectionist barriers. More generally, external liberalisation has made the Brazilian economy more efficient and allowed it to profit from favourable global economic conditions, especially the China-driven resources boom. This has not translated into Chinese and Indian growth rates, but growth looks like it is going up to 6-7 per cent per annum, a big jump from 2.2 per-cent annual growth in the 1990s. This is delivering higher living standards for the broad mass of Brazilians as well as an expanding middle class.

Brazil, like China and India, is in confident mood. Its political stability, economic rise and global integration make it a new force in the world. It has displaced Mexico as the leading power in Latin America, and it is clearly an emerging global power. But, like India, it is still a second-tier emerging power, well behind China.

## RUSSIA<sup>38</sup>

RUSSIA IS EXCEPTIONAL among the BRICS. Since 2003/4, previous market-opening reforms not only stalled; they were reversed and policy went in a strongly *deliberalising* direction. Politics has become increasingly authoritarian; and it has been used by the state to nationalise energy assets, promote monopolistic practices by favoured national champions, and generally apply laws and regulations in a highly selective, arbitrary manner. “State capitalism” is the order of the day. Its external manifestation is “hard mercantilism”. Foreign policy is aggressive towards Russia’s neighbours, its “near abroad”. Arbitrary trade measures, such as cutting off gas supplies to other countries, and unlawful treatment of foreign investors, have become more frequent. Trade mercantilism extends to playing off EU member-states against each other in order to entrench EU energy dependency on Russia.<sup>39</sup>

Russia’s WTO-accession negotiations, which started in 1993, have ebbed and flowed. They slipped down the priority list from 2004, corresponding with more statist policies at home. Prime Minister Putin dropped a bombshell in June 2009 when he announced that Russia would withdraw its solo application to join the WTO and negotiate entry as part of a customs union with Kazakhstan and Belarus. But only a few weeks later, President Medvedev indicated that Russia’s solo WTO application had not been withdrawn. Russia’s relations with the EU and USA have thawed since then; both have concluded bilateral negotiations with Russia as part of its WTO accession process. It now looks like Russia will enter the WTO in 2011.

WTO membership would matter less for Russia than existing WTO membership matters for most other emerging markets. Energy (mainly oil and gas) and other commodities account for 85 per cent of Russia’s exports. Mostly, these products do not suffer from protectionism abroad and are only weakly covered by WTO disciplines; the latter would impose little constraint on Russian government intervention in energy trade. That puts Russia in the same



category as Nigeria and Saudi Arabia. All the other BRICS have much wider swathes of economic activity covered by WTO disciplines. Also, Russia views WTO membership more in foreign-policy than in commercial or economic terms. It is about membership of an important international club in which Russia can exert its influence as a big power; it is much less about using the WTO as a strategic lever for market reforms at home and to integrate Russia into the global economy.

Russia has hardly any cross-regional FTAs and is much less active compared with the other BRICS on this front. That is largely because it is not yet a WTO member; WTO membership would probably trigger many new FTA negotiations. Within the exSoviet Union, however, Russia has negotiated over 20 000 preferential arrangements with newlyindependent neighbours since the early 1990s. These are contradictory, not applied or weakly enforced. A customs union with Kazakhstan and Belarus is supposed to come into force in 2010.

Russia had the severest crisis among the BRICS and has had a relatively modest rebound. It was the worst emerging-market offender in resorting to new protectionist measures. Indeed, the latter was used to strengthen state control of the “commanding heights” of the economy. There were tariff hikes on a range of imports, especially on cars, trucks, buses, steel and agricultural goods. Export tariffs have been slapped on timber. Recently, Russia introduced a ban on wheat exports to combat rising prices. And foreign-investment caps in 40 “strategic” sectors were imposed in 2008. However, the market-liberalising camp in the Kremlin, led by President Medvedev, has been more vocal in the past year, given the depth of the crisis-induced recession. There are modest signs of a course correction, which has led to better relations with Russia’s trading partners. But, so far, this does not amount to a decisive shift of policy in a liberalising direction.

Overall, Russia remains a second-tier emerging-market power. Its influence is primarily in its immediate neighbourhood, but much less evident elsewhere. It is a largely malign influence; and Russia revels in being the regional spoiler.

## SOUTH AFRICA<sup>40</sup>

SOUTH AFRICA IS far smaller than the BRICS by population, with much lower levels of trade and FDI. Its opening to the world economy took place alongside its transition to multi-racial democracy in 1994. As a consequence of trade opening, South Africa better exploits its comparative advantage in capital-intensive primary and manufactured commodities. Trade growth accelerated in 2003-2008, driven by the global commodities boom. On the other hand, export growth compares badly with developing countries generally. South Africa also has low inward investment compared with the BRICS and other emerging markets.

South Africa still has a rather complicated tariff structure. Big pockets of manufacturing protection remain, notably in garments and automobiles. South Africa is also the biggest developing-country user of anti-dumping measures after India. It is generally more open to FDI than China, India and Russia. Its highest levels of protection are in electricity and telcoms. State ownership and restricted competition prevail in transport, telecoms and energy.

South Africa was initially quite pragmatic and flexible in the Doha Round, but it became more defensive after the Cancun Ministerial Conference in 2003. It is especially defensive on industrial-goods liberalisation. It is the mainstay of the South African Customs Union (SACU), and is a member of the wider Southern African Development Community (SADC),

which has (rather far-fetched) plans for a customs union by 2010. SADC's members are too disparate for it to be viable; and SACU is undermined by overlapping FTAs with third countries. For example, South Africa has a separate FTA with the EU; and other SACU members, but not South Africa, have signed an interim Economic Partnership Agreement (EPA) on goods trade with the EU. South Africa now prioritises "South-South" FTAs with other developing countries, notably India and Brazil. These are "trade-light" agreements: some are "partial-scope", limited to tariff preferences on a narrow range of products; others may be more ambitious on tariff elimination, but do not reduce non-border regulatory barriers in goods, services, investment and public procurement.

External liberalisation has stalled since the late 1990s. Liberalisation-scepticism has set in; and trade and related structural reforms have fallen way down the list of government priorities. Mercantilism prevails: unilateral liberalisation is off the agenda; and trade negotiations are driven more by geopolitical than commercial considerations. Defensiveness in the WTO and trade-light South-South FTAs with countries with which South Africa does relatively little trade are not congruent with South Africa's export interests. The latter are not only in agriculture, but also in intermediate manufactures and services, especially to other African countries. Meanwhile, government attention has shifted to sector-based industrial-policy intervention.<sup>41</sup>

These trends have become more pronounced under the Zuma administration. There is more pressure from COSATU (the trades union umbrella organisation), the South African Communist Party and the left-wing of the African National Congress to step up industrial-policy intervention and even trade protection. Tariffs on garments were increased in late 2009. Generally, though, the government has refrained from major protectionist measures in response to the global economic crisis.

South Africa's core economic problems are very high unemployment, anaemic employment growth, low productivity, low standards of education and skills, and lack of diversification, especially into employment-generating services sectors. Trade liberalisation is often – and mistakenly – blamed for exacerbating some of these problems. On the contrary, remaining protection keeps business costs high and firms uncompetitive, in addition to taxing – especially poor – consumers. But more damage is done by domestic (though still trade-related) regulatory barriers, for example in transport, telecoms and energy. Employment policies are the most damaging set of regulatory barriers; and these have become more restrictive. They act as a powerful deterrent to domestic as well as foreign investment. They are also intimately bound up with affirmative-action policies (termed BEE – Black Economic Empowerment) in the name of the black majority.

President Zuma has announced that South Africa intends to be bracketed with the BRICS as an emerging-market powerhouse. This is hype. South Africa does have leadership credentials in southern and sub-Saharan Africa. But that is the extent of it. It is too small to be in the same league as India and Brazil, let alone China. It does not have the dynamism, the education and work ethics one finds in Asia in particular. Rather it is plagued by European-like vices: overweening trades unions, restrictive work practices and a redistributive, not growth-oriented, ideology. Its inevitably complicated racial politics also holds back a growth take-off. At best, South Africa can be a third-tier emerging-market power.

## 7. EMERGING MARKETS IN REGIONAL AND GLOBAL TRADE GOVERNANCE

THE DOHA ROUND remains stuck, with no serious prospects for conclusion in 2010. None of the major players gives it more than lip-service; and their attentions have been diverted to domestic fire-fighting by the crisis. Besides, the Doha Round, even if concluded, would do little to contain emerging protectionism beyond binding developing-country tariffs at lower levels. And a serious post-Doha agenda for the WTO lies on the distant horizon. As a result, the WTO suffers from a slow-burning credibility crisis.

The USA, EU and major emerging markets – especially China, Brazil and India -- should prioritise two objectives, and invest political capital accordingly. The first objective must be to finish the Doha Round as soon as possible; the other to move on to a post-Doha agenda that addresses twenty-first century trade realities. They should aim for a modest Doha package – “Doha-lite” as it were – that can be concluded expeditiously. High ambition is politically undeliverable. The main thing is to despatch the Doha Round so that it does not continue to block WTO business and further undermine its rules. Then the WTO could move on to a post-Doha agenda that would fill in gaps in multilateral trade rules – not least to contain the creeping regulatory protectionism that may have accelerated in the wake of the crisis.

But breaking the WTO’s logjam requires filling a leadership vacuum. The USA has largely forsaken its traditional leadership role in the GATT/WTO. The EU is not attempting to substitute for the USA, nor could it do so on its own. The big three emerging-market WTO members, China, Brazil and India, are clearly much more important, but they remain reactive players in the WTO, happy to leave logjam-breaking initiatives to the USA and EU. They have not made the transition to co-leadership. Without cooperation and co-leadership among this group of five, WTO negotiations are unlikely to move. Finally, middle powers like South Africa and Indonesia should play constructive supporting roles, but they have been conspicuously defensive and obstructive in the Doha Round.

The G20 makes more sense than the G8: it is more representative of national weight and clout in the global economy. But it is much-hyped. Predictably, there were grand aspirations for it as a new and powerful instrument of global governance. Initially, and on the surface, there was collective agreement to loosen macroeconomic policies to combat the crisis. But, subsequently, G20 members have gone their separate ways on macroeconomic policies, and attempts at G20 coordination of exchange rates and global imbalances in a “Plaza II accord” have conspicuously failed. It remains to be seen how strong collective commitments on financial regulation will be in practice. Last, collective pledges to refrain from new protectionist measures were never taken seriously.

G20 splits are unsurprising: it is too large and unwieldy to be a cohesive forum for international policy coordination. To work, it requires outward-looking leadership by its major players, led by the United States and China. But, as argued above, they are both in defensive mode. So is the EU. Worse, the EU does not speak with one voice in the G20, rather speaking discordantly through its represented member-states, especially the UK, Germany and France. That is symptomatic of the EU’s over-hyped soft power in international relations.

Overall, the G20 may be a welcome chat forum, but it has distinct limits as a heavyweight forum for global governance, least of all on trade policy. Deep-seated differences among G20 members on underlying economic policies have prevented and will prevent “hard coordination” of *anything* – trade, macroeconomic policy, financial regulation, structural reform or anything else for that matter. In that sense the G20 is no different from the G8. “Soft” cooperation is the best that can be achieved; hard coordination is a will-o-the-wisp.

One key factor that prevents emerging powers from rising faster is highly malintegrated regional markets.<sup>42</sup> That is true of Latin America, Africa, the ex-Soviet Union, south Asia and east Asia.

In the developing world, regional trade integration is most advanced in east Asia. Cross-border economic integration has increased: intra-regional trade is about 55 per cent of total trade, roughly halfway between comparable numbers for the EU and NAFTA. But this is mostly due to intra-regional trade in parts and components, mainly in ICT products, with final assembly in China and exports of finished goods to Europe and North America. In other words, greater regional trade integration is a product of *increasing* dependence on the West. This is quite different to regional trade integration in Europe and North America, where most regional production is destined for regional consumption. In east Asia, national policy barriers and lack of infrastructure prevent regional integration in agriculture, services and other parts of manufacturing.

As for south Asia, it is the least-integrated region in the world economy: intra-regional trade is barely above 10 per cent of total trade; and it is only 5 per cent of regional GDP. India's trade with its neighbours is only 3 per cent of its total trade. Also, south Asia is not yet plugged into east-Asian and global supply chains. It accounts for only 5 per cent of Asia's trade and 1.4 per cent of world trade. The pattern in Latin America and the Caribbean, sub-Saharan Africa, north Africa and the Middle East, is closer to the south-Asian pattern than that in east Asia.

Regional-integration boosters argue that region-wide FTAs, monetary and financial cooperation, cross-border infrastructure and growing domestic consumption will knit together regional markets, create regional supply chains for regional consumption – and lessen dependence on the West. These arguments are either wrong or highly premature.

First, developing-country FTAs are generally trade-light: they barely liberalise trade or improve upon WTO rules. At best they eliminate most tariffs, but they hardly tackle non-tariff and regulatory barriers that are bigger obstacles to intra-regional commerce. That is the east-Asian picture, centred on the ASEAN Free Trade Area (AFTA) and ASEAN FTAs with third countries, notably China, Japan, India and Australia/New Zealand. Many other FTAs are even weaker, limited to less-than-comprehensive tariff elimination or reduction. China, India, Brazil, South Africa and Indonesia have a mix of these FTAs; Russia's preferential trade agreements are even weaker.

Second, there are several regional-integration initiatives on the table in the developing world. In Asia, these are centred on regional institutions such as APEC, ASEAN and SAFTA. At the top of the list are ideas for east-Asian and pan-Asian FTAs. There are parallel initiatives in Latin America, Africa and the ex-Soviet Union. But, for the foreseeable future, these institutions will likely remain quite weak; and regional-integration initiatives are unlikely to go beyond “soft cooperation”. At best they can be chat forums to gradually build confidence and trust, exchange information and ideas, improve transparency, and promote trade facilitation and other “best-practice” measures. But this is unlikely to be transformed into “hard cooperation” with binding, enforceable rules. Intra-regional divisions – countries at widely different stages of development, competing producer interests, significant intra-regional trade barriers, rivalry among regional powers (such as China, India and Japan in Asia), and,

not least, a history of bitter nationalist rivalries and lack of cross-border cooperation – will continue to stymie regional integration for a long time to come.

Yet other factors inhibit emerging powers from exercising leadership in regional and global economic governance. To pick out three:

First, domestic political and economic systems. Most emerging-market political systems, ranging from democracy to authoritarianism, can at best react to changing global conditions; but they lack the capacity and flexibility to be proactive in their regions and around the world. Economic institutions – public administration, enforcement of property rights, diverse regulatory authorities – remain relatively weak and keep business costs high, repressing entrepreneurship, innovation and consumption.

Second, geopolitical obstacles. None of Asia's big three powers, for example, is in a position to exercise outright regional leadership. This is not simply a matter of domestic constraints or the lack of a tradition of external leadership. Most countries in Asia do not want Chinese "hegemony", just as they are wary of a resurgent Japan. Rather they prefer a multipolar regional balance of power, with a vital role for the US as the region's "balancing power". Also, it is true that stronger economic links among emerging markets help to contain their political tensions and conflicts. But security flashpoints remain, and they will present enduring threats, not least over competition for natural resources.

And third, limits to emerging powers' role in global economic governance. China, Brazil and India have greater power in international institutions such as the WTO, World Bank, IMF, and now the G20. They are stronger in bilateral relations with other powers, notably the USA. Japan should be in the same category, but it is constrained by its post-war geopolitical settlement and internal sclerosis. Middle powers such as South Korea, Indonesia, Australia and South Africa have important niches to fill. But none of them are willing to exercise onerous global – or even regional – responsibilities. Not one of the BRICS – not even China – is remotely close to assuming the kind of responsibilities the USA has undertaken around the globe since the Second World War.

## CONCLUSION

THE GLOBAL ECONOMIC crisis has sparked short-term divergence of economic performance between the West and emerging markets, and thereby accelerated the longer-run convergence of the latter on the former. That is particularly evident in globalising Asia. This Shift to the East is also even more evident in international trade and FDI than it is in other channels of globalisation. And it creates very different economic and geopolitical conditions to those that prevailed under US leadership and a transatlantic-centred world economy in the second half of the last century. Western and emerging-market elites are only just beginning to recognise this shift, but they still have little clue how to deal with it.

But emerging markets' political and economic institutions, and intra-regional divisions, continue to hold back their rise. That means the Shift to the East will not translate into Chinese or other emerging-market leadership for a long time to come – if ever. The USA is still the fulcrum of international relations, and the world is far from being "post-American". But the USA is diminished; it is less capable and willing to exercise global leadership – clearly evident under the Obama administration. Europe is also no substitute for US leadership. The EU has the world's biggest unified market. But that is the extent of the EU's global power. Its hybrid

nature, internal divisions and absence of hard power (a unified military capacity) will always prevent it from having a serious, coherent foreign policy. Its soft power, outside the greater European neighbourhood, is mostly postmodern hot air.

Thus the economic shift to emerging markets, accelerated by the crisis, does not translate into a paradigmatic shift in global political-economic order. But it does insert more multipolarity and uncertainty into that order, and leaves more of a leadership vacuum.

These are very general global political-economic observations, but I think they also capture the present global trade-policy context. As for trade policy, governments' responses to the biggest deglobalisation since the Depression did not precipitate a descent into 1930s-style protectionism. Domestic crisis interventions – a combination of bank bailouts and expansive macroeconomic policies – took priority. Traditional protectionism hardly increased; borders remained open. But crisis interventions and the return to Big Government leave the West with crippled public finances and more restrictions on competitive markets. Also, they threaten to spill over into creeping protectionism of the subtle, non-tariff, regulatory variety. New patterns of protectionism are similar to developments in the 1970s and 1980s rather than the 1930s. They are barely contained by WTO rules. The danger is that they will slow down recovery and reglobalisation in the next decade.

The short-term challenge is to arrest the slide to Big Government at home and creeping protectionism abroad. The medium-term challenge is to get back on track with trade and FDI liberalisation combined with domestic structural reforms – substantial unfinished business left before the crisis struck. The BRICS and many other emerging markets still have big pockets of up-front trade and FDI protection. They have even higher domestic (though still trade-related) barriers embedded in services regulation, intellectual property rules, public procurement, customs administration, food-safety and assorted product standards, and competition rules. They do badly on business-climate indicators compiled by the World Bank and other organisations. But “second-generation” reforms to tackle these barriers are much more complex and politically sensitive than the “first-generation” reforms of the Washington Consensus heyday. Compared with border barriers to trade and FDI, domestic regulatory barriers are defended by more powerful, entrenched interest groups, uniting insider elites in government, business and unions, usually with the public sector and the organs of the state at their core.

Notwithstanding these great obstacles, these reforms are primarily a matter for *unilateral* action by governments and *competitive emulation* among them. They can be reinforced by international policy cooperation in the WTO, G20 and other fora, but not too much can be expected of cumbersome global-governance, let alone regional-governance, mechanisms.

On a final contextual note, the global economic crisis has brought Keynesian macroeconomics back to fashion, and with it Pigovian welfare economics – microeconomic interventions to fix alleged market failures. A social-engineering mentality – the belief that superior technocratic minds can solve complex social and economic problems with targeted interventions – has been in the ascendant. Welcome to the world-view of Mr. Bentham, Mr. Keynes, Mr. Stiglitz and Mr. Krugman. That of Mr. Hume, Mr. Smith and Mr. Hayek – the belief that markets are complex organisms; that governments, however expertly staffed, cannot possibly have enough knowledge to “fine-tune” macro- and microeconomic outcomes with detailed, prescriptive regulations; that governments also “fail” through human fallibility, political pressure and corruption; and, consequently, that regulation should err on the side of caution and stick to general rules to allow markets to operate effectively – has become less popular.<sup>43</sup>

I happen to side with the classical-liberal sages on both domestic and international economic policy. Overall, *limits* to government intervention and a well-functioning market economy are of a piece with open markets, economic globalisation and international political stability.

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